

November 26, 2008

MEMORANDUM

TO: Senator John Arthur Smith, LFC Chair
Legislative Finance Committee Members

FROM: Dan White, LFC Economist
Michelle Aubel, LFC Senior Fiscal Analyst

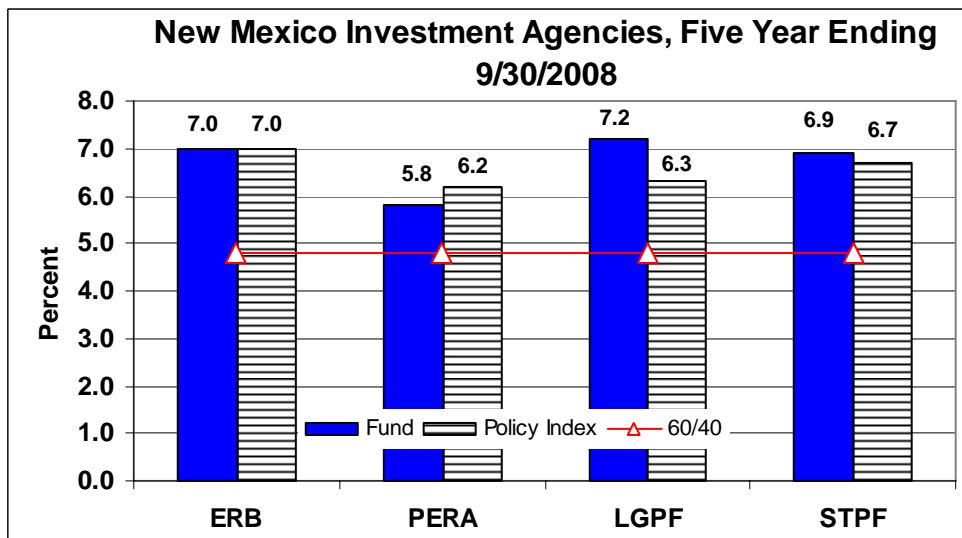
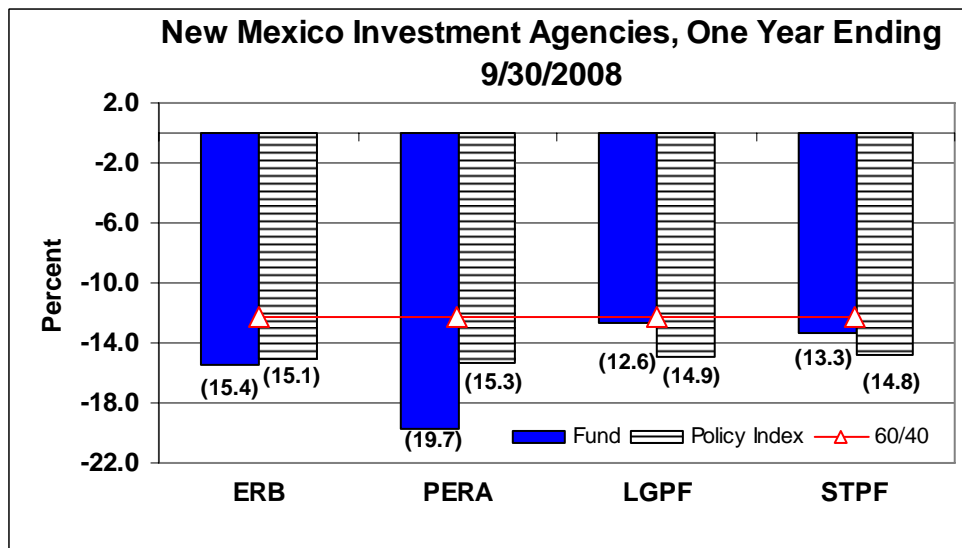
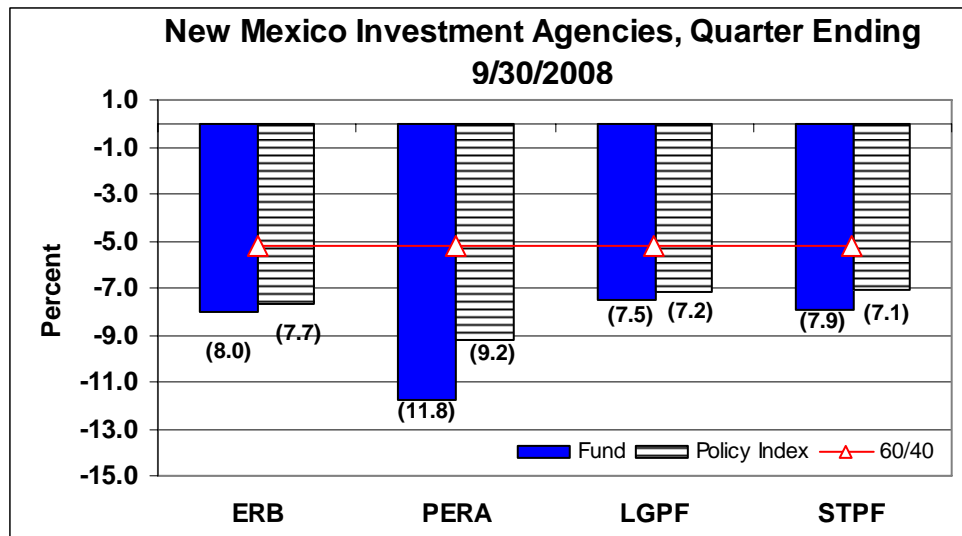
SUBJECT: LFC Report of Investment Performance – FY2009 First Quarter

Investment Performance Highlights:

- Due to highly turbulent financial market conditions throughout the quarter, all state investment fund returns were significantly negative, and underperformed quarterly benchmarks.
- Despite the poor quarterly performance, both permanent funds under the management of the State Investment Council (SIC) are still beating annual and 5-year benchmark returns. The Land Grant Permanent Fund's (LGPF) annual return beat its policy benchmark by 230 basis points¹ (bps) and the Severance Tax Permanent Fund (STPF) beat its annual benchmark by 150 bps.
- Both pension funds continue to miss policy benchmarks for both quarterly and 1 year returns. The Public Employee Retirement Association (PERA), in particular, performed poorly, missing its quarterly performance benchmark by 255 bps. The fund's five-year performance has now fallen below its policy benchmark by 38 bps. The Educational Retirement Board (ERB) underperformed its quarterly policy benchmark by 30 bps, and its 5 year return is now even with its policy benchmark.
- The combined asset value of all funds totaled \$32.25 billion at quarter's end, representing a net decrease of \$3.3 billion or 9.4 percent from the prior quarter. The massive quarterly decrease makes up more than half of the nearly \$6.5 billion loss in value the funds have suffered over the last twelve months. Fund values continue to plummet in the second quarter of FY09. Significant decreases in fund values impact annual LGPF and STPF distributions to the general fund. The potential impacts of these decreases are discussed in more detail in this quarter's special focus section.
- The poor returns delivered thus far by the pension funds raise significant concerns as to their funding status. Both funds need to meet an 8 percent average return in order to adequately fund future retirement payments.

¹ A basis point is equal to a hundredth of 1 percent (0.01%).

OVERALL FUND PERFORMANCES vs. RELATIVE BENCHMARKS



FUND ASSET VALUES

Fund asset values declined significantly during the first quarter. Total asset values for the four funds experienced a combined decrease of \$3.34 billion, or 9.4 percent, during the quarter. PERA suffered the largest percentage decrease, losing 12 percent of its total asset value during the quarter. Total asset values for all funds decreased by nearly \$6.5 billion or 16.6 percent for the year. Though volatility is mitigated through a five-year smoothing process, a continuation in this sharp decrease in asset values will have long-term impacts on permanent fund distributions to the general fund.

Current Asset Values (millions)
For Quarter and Year Ending September 30, 2008

Quarterly	ERB	PERA*	LGPF	STPF	TOTAL
Current Asset Values (9/30/08)	\$ 7,986	\$ 10,726	\$ 9,537	\$ 3,977	\$ 32,225
Value Change (Previous Quarter)	(756)	(1,465)	(734)	(391)	(3,346)
Percent Change	-8.6%	-12.0%	-7.1%	-8.9%	-9.4%

Annual	ERB	PERA*	LGPF	STPF	TOTAL
Ending Asset Values (9/30/08)	\$ 7,986	\$ 10,726	\$ 9,537	\$ 3,977	\$ 32,225
Value Change (Year Ago)	(1,600.4)	(2,762.8)	(1,308.6)	(751.9)	(6,423.7)
Percent Change	-16.7%	-20.5%	-12.1%	-15.9%	-16.6%

*Excludes assets held at STO

ECONOMIC AND FINANCIAL MARKET ENVIRONMENT

Investment Benchmarks and Economic Indicators

Benchmarks		Returns		
Domestic Equity		Quarter	One-Year	Five-Year
	S&P 500 Index	-8.4%	-22.0%	5.2%
International Equity				
	MSCI EAFE Developed	-20.6%	-30.5%	9.7%
Fixed Income				
	Barclays Capital (BC) Aggregate Index*	-0.5%	3.7%	3.8%
Alternatives				
	Real Estate NCREIF Index	0.6%	9.3%	14.7%
	Cambridge Venture Capital Private Equity	1.0%	5.1%	23.1%
	Absolute Return - 90 Day T Bill + 200 bps	1.0%	5.0%	5.6%

*All Lehman Brothers indices now reflect the Barclays Capital name.

Economic Indicators	Q4 FY08	Q1 FY09	Q2 FY09**
Real GDP Growth	2.80%	-0.30%	-3.30%
Core Consumer Price Index	2.50	2.70	2.00
Unemployment Rate	5.50%	6.00%	6.50%

**Q2 FY09 Global Insight Forecast

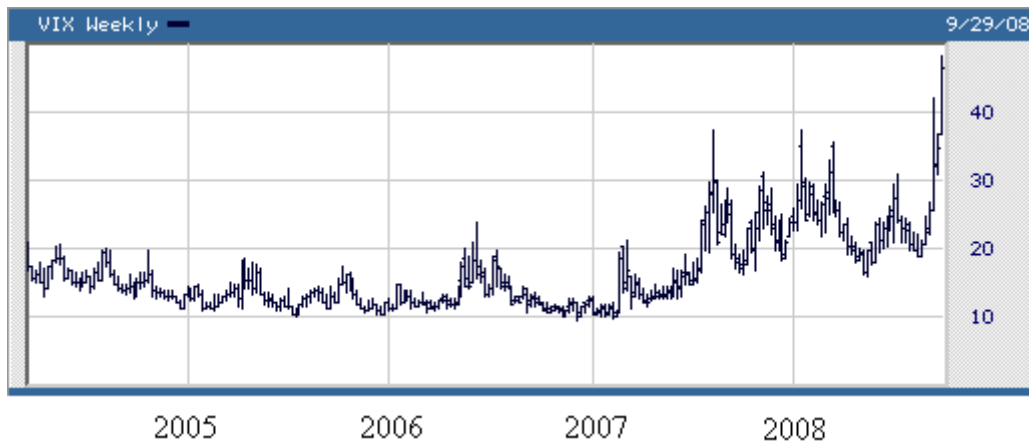
FY09 started off with one of the worst performing, most unpredictable quarters since the 1930s. Even before the September 15th bankruptcy filing of Lehman Brothers, the Standard and Poor's 500 Index (S&P 500) was down nearly 2.5 percent and treasury yields were nearly zero. After Lehman's bankruptcy filing, two other important financial firms, Merrill Lynch and American International Group (AIG), were nearly forced into bankruptcy as well. These events prompted Congress to pass the \$700 billion Economic Stabilization Act, intended to inject liquidity into the failing credit markets and protect consumers and businesses from sharp decreases in lending. Although implementation of

Quarterly Investment Report, 1st Quarter - Fiscal Year 2009

the act has proceeded quickly, most economists believe it will be months if not years before its full impacts are felt. Treasury officials have repeatedly expressed frustration at banks' continued reluctance to lend.

Credit markets performed exceptionally poorly throughout the first quarter. The enormous amount of uncertainty throughout all financial markets once again caused investors to run for the safety of treasuries, causing yields to plummet. Yields on 30-day treasuries were at one point pushed as low as a tenth of one percent, equivalent to a negative yield when adjusted for inflation. The immense market uncertainty caused overnight lending and commercial paper markets to freeze up completely. Because of the poor borrowing conditions, new issuances became virtually non-existent, putting further pressure on existing yields.

Equity markets, the most visible of global financial markets, were also extremely volatile throughout the quarter. The VIX or volatility index, a measure of investor fear traded daily on the Chicago Board of Options Exchange (CBOE), reached unprecedented levels during the quarter.



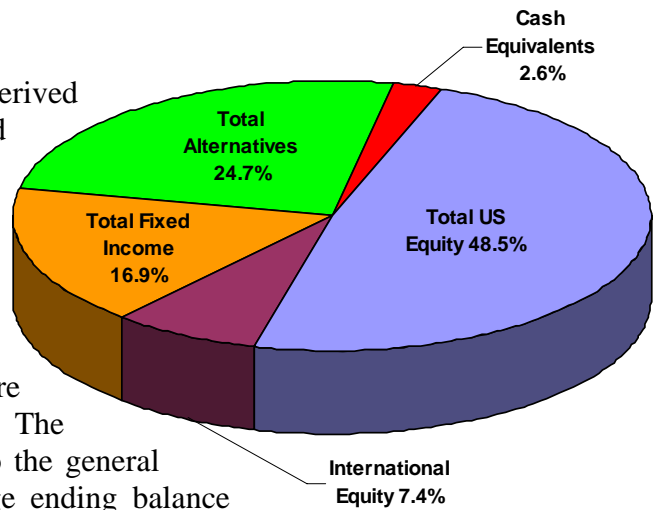
Source: Chicago Board of Options Exchange

These historic levels of volatility resulted in fearful investors pulling their money out of equity markets. The S&P 500 lost nearly 8 percent of its value in the last week of September alone, finishing down 8.9 percent for the quarter. On September 29th, after the U.S. House of Representatives voted down a first draft of the Federal Economic Stabilization Act, the Dow Jones Industrial Average (DJIA) fell a record 778 points in one day. Financial markets have continued to slide throughout the beginning of the second quarter as well. Economic indicators echoed the dismal returns prevalent throughout financial markets. Gross Domestic Product (GDP) actually decreased 0.5 percent during the quarter a sharp decline from the 2.8 percent growth experienced a quarter earlier. Although inflation has moderated sharply since the end of the quarter, the consumer price index increased from 2.5 to 2.7 during the quarter. National unemployment also increased from 5.5 percent to 6 percent during the quarter. Numerous other economic indicators suggest that the U.S. economy is currently in recession.

Land Grant Permanent Fund (LGPF)

Fund Objective: The LGPF is derived from proceeds of sales of state and federal public lands and royalties from mineral and timber production on state lands. The fund is invested by the state investment officer according to the Prudent Investor Act seeking to preserve capital for future generations of New Mexicans. The fund makes annual distributions to the general fund of 5.8 percent of the average ending balance from the previous five calendar years, which support the operations of public schools and various other beneficiaries.

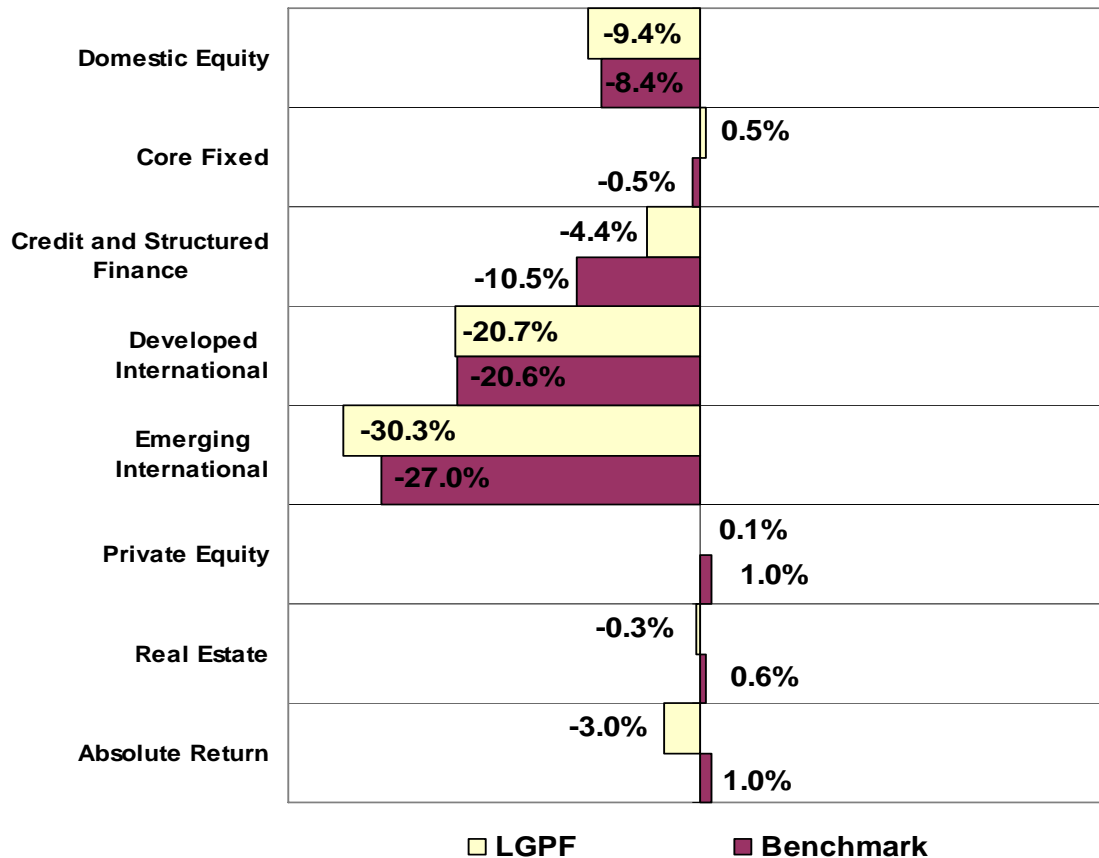
LGPF Asset Allocation as of 9/30/08



Fund Performance vs. Policy Benchmarks

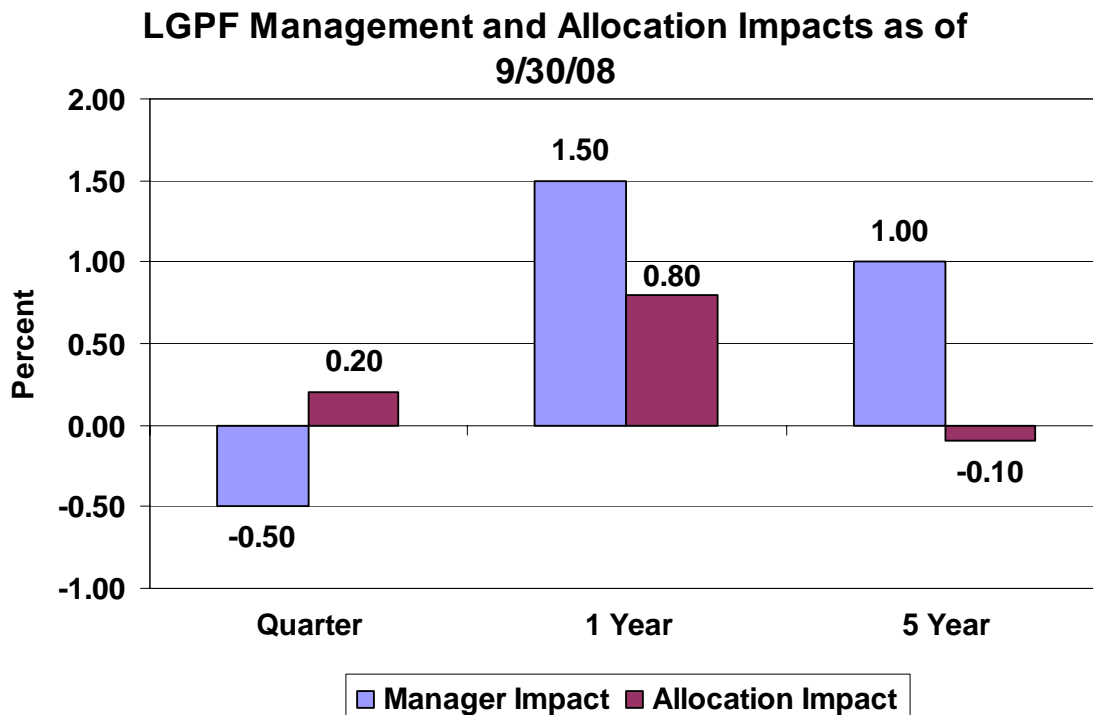
Quarter			1 Year			5 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
-7.50%	-7.20%	30	-12.60%	-14.90%	24	7.20%	6.30%	25

LGPF Quarterly Performance vs. Benchmarks



Contributing Factors: The LGPF missed its overall policy benchmark by 30 bps but is still outperforming its annual benchmark by an impressive 230 bps. The LGPF 5 year performance remains in the top quartile compared with all other U.S. public funds. Due largely to its domestic equity hedging program, the LGPF has been able to significantly outperform benchmarks over the last two quarters. After the Lehman Brothers bankruptcy and the subsequent increase in counterparty risk however, the SIC closed all of its hedged positions in mid-September. Because of this, not only were the fund's domestic equity returns unable to once again offset dramatic losses in other asset classes, they missed their own benchmark by 100 bps as well. The LGPF also underperformed significantly throughout its alternative investment portfolio and international equity investments. Although the fund underperformed in all alternative areas relative to benchmarks, the fund's absolute return or hedge fund investment returns were by far the weakest. Hedge fund investments, as an asset class, have performed extremely low relative to historic returns over the past few months due to the current financial crisis. The LGPF underperformed dismal benchmarks with its international equity portfolio as well, missing its emerging markets benchmark by more than 300 bps. Fortunately for the LGPF, the effects of its international equity returns were mitigated by the asset class' relatively small asset allocation within the overall portfolio.

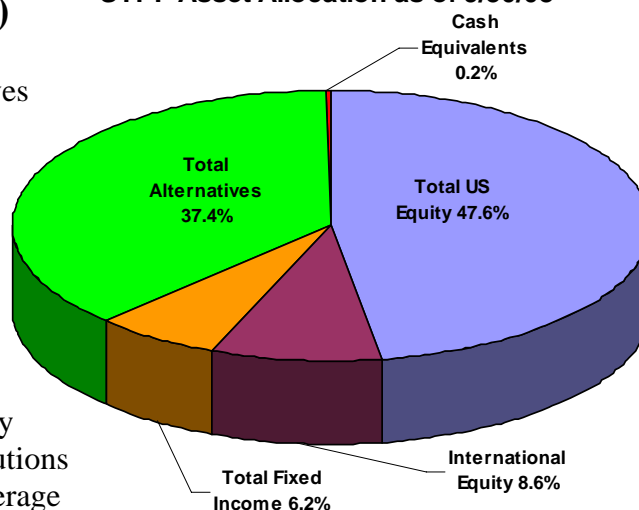
Management and Allocation Impacts: In the first quarter of FY09, active management cost the overall fund's return 50 bps while asset allocation added 20 bps. The negative impact of active management was unusual for the LGPF as active management has added at least 100 bps to both the 1 year and 5 year returns. This phenomenon is likely the result of the extraordinary amount of volatility present throughout financial markets during the quarter. From a long-term perspective, active management has added significant value to the fund's overall returns and should continue to do so once financial markets stabilize.



Severance Tax Permanent Fund (STPF)

Fund Objective: The STPF receives contributions from the portion of severance tax proceeds not required for retirement of severance tax bonds. The fund is invested by the state investment officer under the Prudent Investor Act seeking to preserve capital for future generations of New Mexicans. The fund currently makes annual general fund distributions consisting of 4.7 percent of the average ending balance from the previous five calendar years.

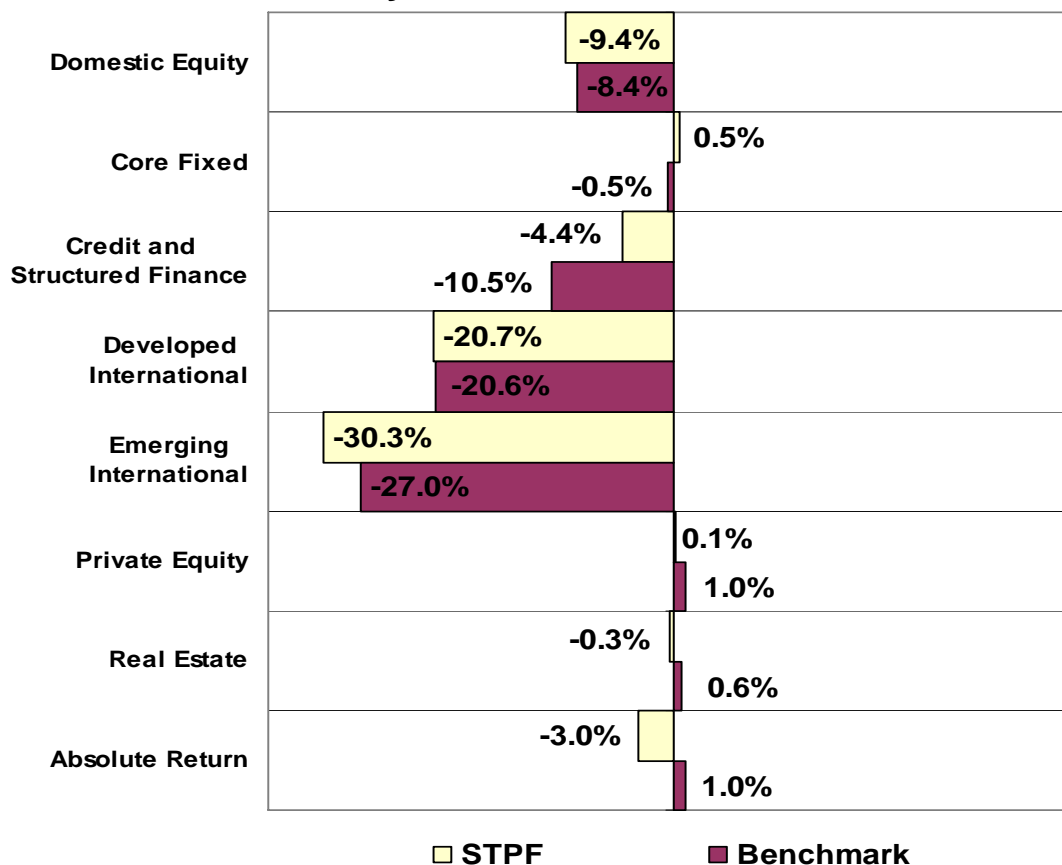
STPF Asset Allocation as of 9/30/08



Fund Performance vs. Policy Benchmarks

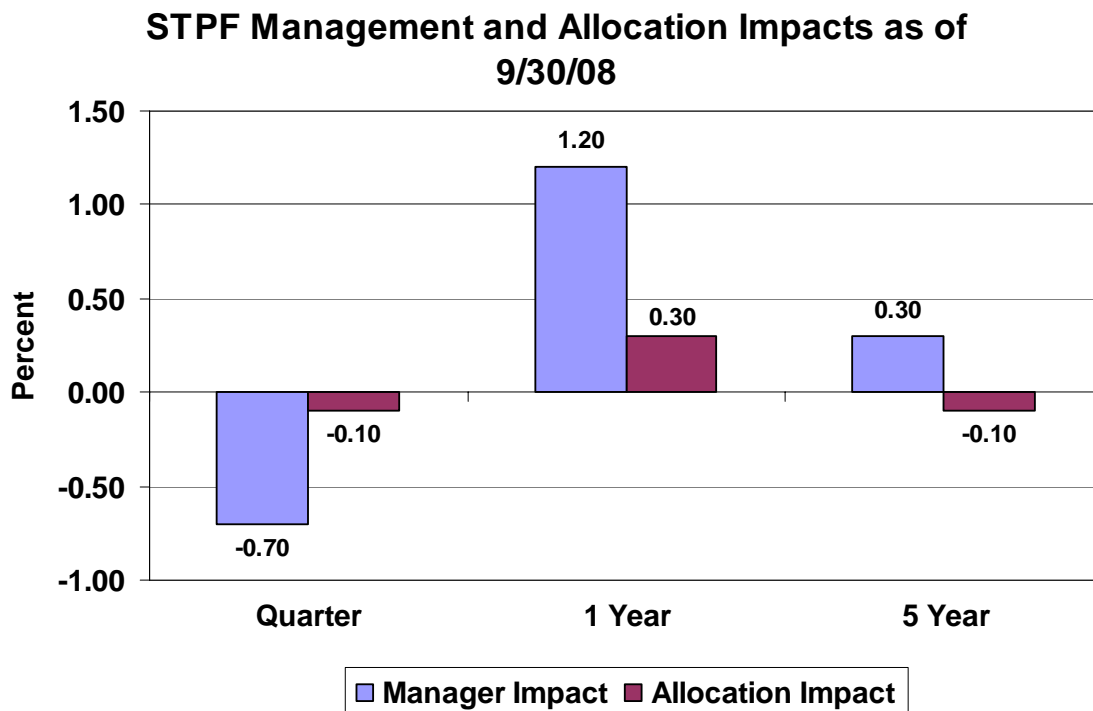
Quarter			1 Year			5 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
-7.90%	-7.10%	36	-13.30%	-14.80%	32	6.90%	6.70%	33

STPF Quarterly Performance vs. Benchmarks



Contributing Factors: The STPF missed its overall policy benchmark by 80 bps but is still outperforming its annual benchmark by 150 bps. Despite poor quarterly returns, the STPF's quarterly, 1-year, and 5-year performances still rank in the 36th percentile or higher compared to other public funds. The various assets within the STPF performed essentially identical to those of the LGPF. The reason that the LGPF outperformed the STPF by 40 bps is due almost entirely to the difference within the funds' asset allocations. During the first quarter of FY09, the STPF had much higher alternative asset and international equity allocations, which were the two worst performing asset classes. The LGPF by contrast had a significantly higher allocation to fixed income assets, which were by far the strongest performers of the quarter. The differences in the funds' allocations are due primarily to the funds' slightly differing objectives. Unlike the LGPF, the STPF maintains a 9 percent portfolio allocation for economically targeted investments or ETI. The ETI program contains various investments through the New Mexico Private Equity Investment Program (NMPEIP), the Film Investment Program, as well as direct investment into New Mexican companies. In addition to bottom line investment returns, the ETI program also seeks to stimulate economic development throughout the state. For this reason, STPF's alternative asset allocation in ETIs usually results in lower returns, as occurred in the first quarter of FY09.

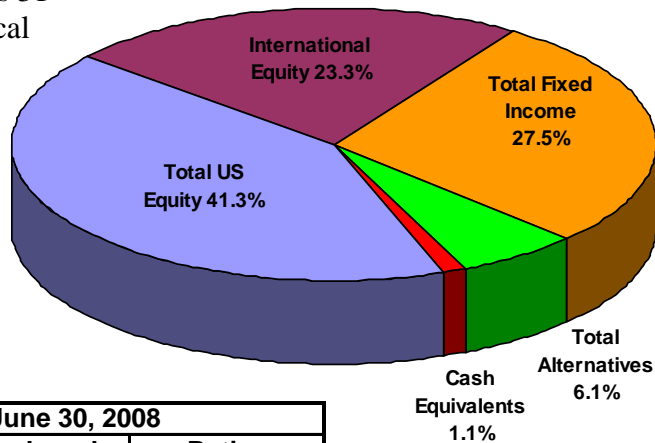
Management and Allocation Impacts: In the first quarter of FY09, active management and asset allocation cost the STPF's overall return 70 bps and 10 bps, respectively. The allocation impact, discussed in more detail in the previous section, was 30 bps lower than the LGPF. Like the LGPF, negative manager impact is an unusual occurrence for the STPF, having added value to both its 1-year and 5 year returns. Accordingly, active management should once again add value to overall fund performance once financial markets begin to stabilize.



Public Employees Retirement Association (PERA)

Fund Objective: PERA administers 31 pension plans covering state and local government employees, volunteer firefighters, judges, magistrates and legislators to provide secure retirement. The fund is invested according to the “prudent investor rule” and results are reported in the aggregate.

PERA Asset Allocation as of 9/30/08



Actuarial Status as of June 30, 2008			
	Fund	Benchmark	Rating
Funded Ratio*	93%	80%	G
Trend	↓ Due to decline in asset values.		

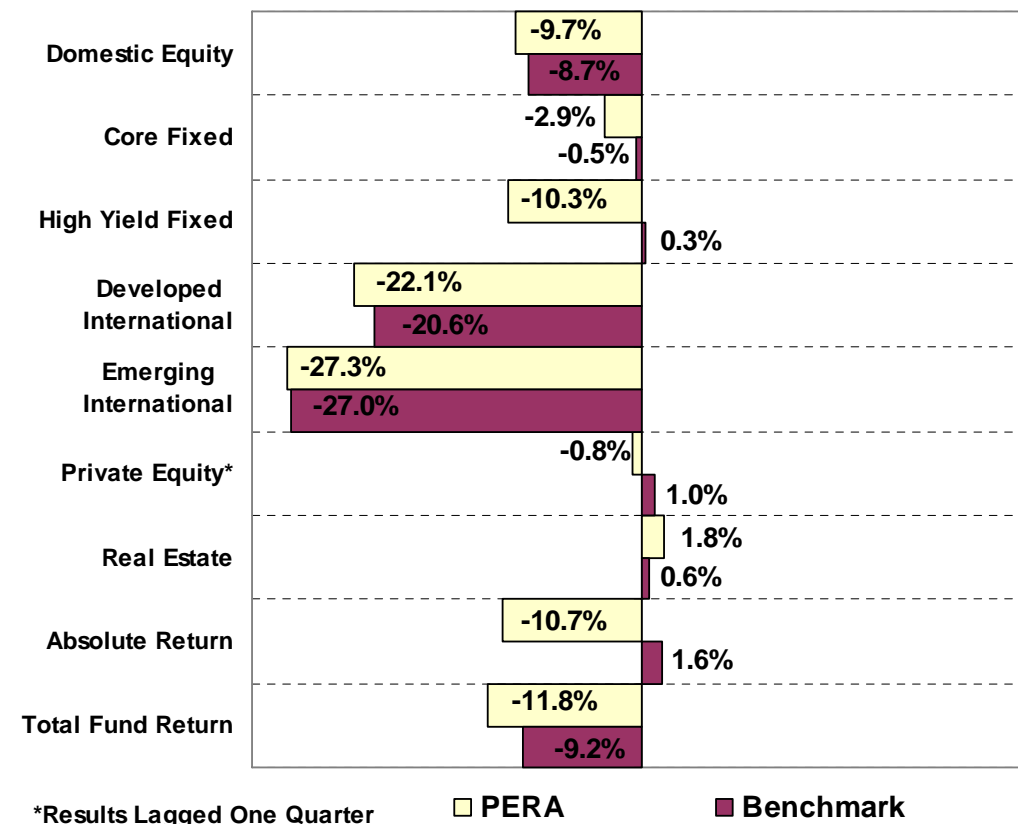
*Percent of actuarial value of assets to plan liabilities.

Fund Performance vs. Relative Benchmarks*

1 Year			5 Year			10 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
-19.69%	-15.27%	96	5.82%	6.2%	78	6.34%	5.26%	44

*PERA also has an 8 percent actuarial benchmark for funding purposes.

PERA Quarterly Performance vs. Benchmarks



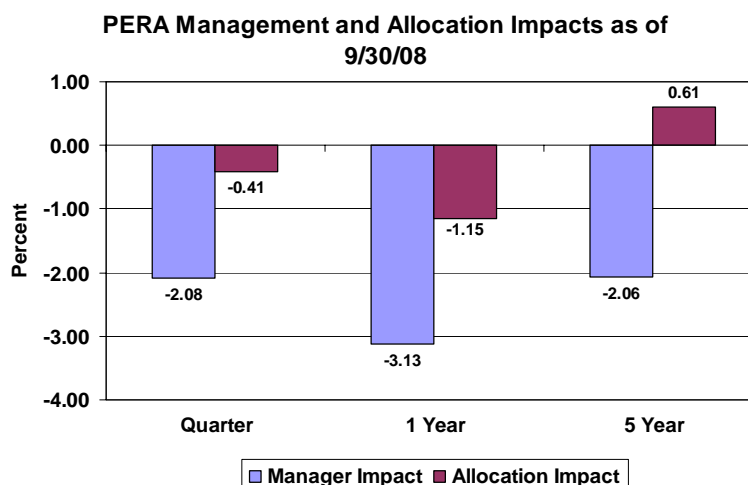
Fund Balance (in millions)*			
September 30, 2008	June 30, 2008	September 30, 2007	September 30, 2003
\$10,725.5	\$12,190.8	\$13,488.3	\$8,146.3

*Excludes assets held at the State Treasurer's Office.

Overview: PERA missed its overall policy benchmark by 255 bps for the quarter, placing PERA in the 92nd percentile of public funds for this period. The one-year underperformance of 442 bps dropped the fund's 5 year returns to 5.82 percent, 38 bps below its policy benchmark. Of greater concern is the 10-year result, which is now significantly less than the actuarial long-term target of 8 percent. Unless a major rebound occurs in the second half of FY09, PERA's funding status will undoubtedly decline.

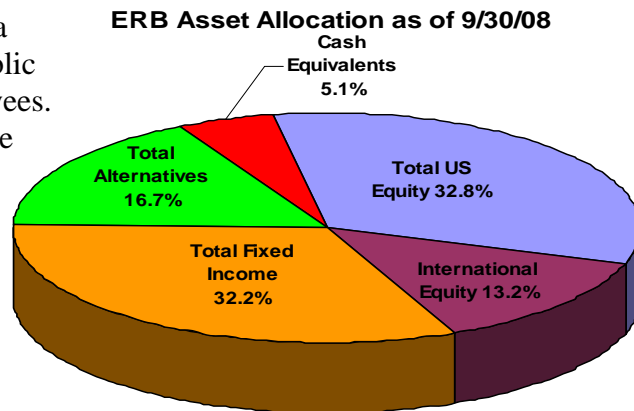
Management and Allocation Impacts: Approximately 16 percent of PERA's underperformance for the quarter, or \$53 million, is attributable to asset allocation differing from policy targets. An underweight to the relatively well-performing core fixed income segment and an overweight to the poor-performing international sector were the two major factors. The same pattern is reflected for the year, with an underweight in fixed income subtracting 94 bps of the overall 115 bps underperformance attributed to asset allocation. For most of this time, U.S. treasuries were the only asset class to consistently post positive returns.

Continued management underperformance by PERA's external investment managers accounted for \$269.1 million of the decline in asset value for the quarter when all. All composites performed below benchmarks. In the past twelve months alone, manager underperformance has reduced the fund's return by more than 300 bps. Fixed income managers, mainly Franklin and Western Asset, contributed 143 bps of that underperformance, which is most likely due to holding assets other than U.S. treasuries in portfolios. The remainder of underperformance by fixed income managers, approximately 170 bps, was attributable to a manager whose contract was terminated early in FY09. Underperformance of the international equity composite of negative 85 bps is due primary to the Alliance Bernstein value investment style. The alternative asset portfolio subtracted 90 bps. Only the domestic equity posted a slight positive out-performance of 5 bps for the one-year period. Addressing this underperformance, PERA has terminated two managers within the last four months and has placed two more on the watch list.



Educational Retirement Board (ERB)

Fund Objective: ERB administers a defined benefit pension plan for public school and higher education employees. The fund is invested according to the “prudent investor rule” to ensure retirement benefits. As of June 30, 2008, ERB has 31,192 retirees and 63,698 active members.



Actuarial Status as of June 30, 2007			
	Fund	Benchmark	Rating
Funded Ratio*	70.5%	80%	R
Trend	↓ Due to decline in asset values.		

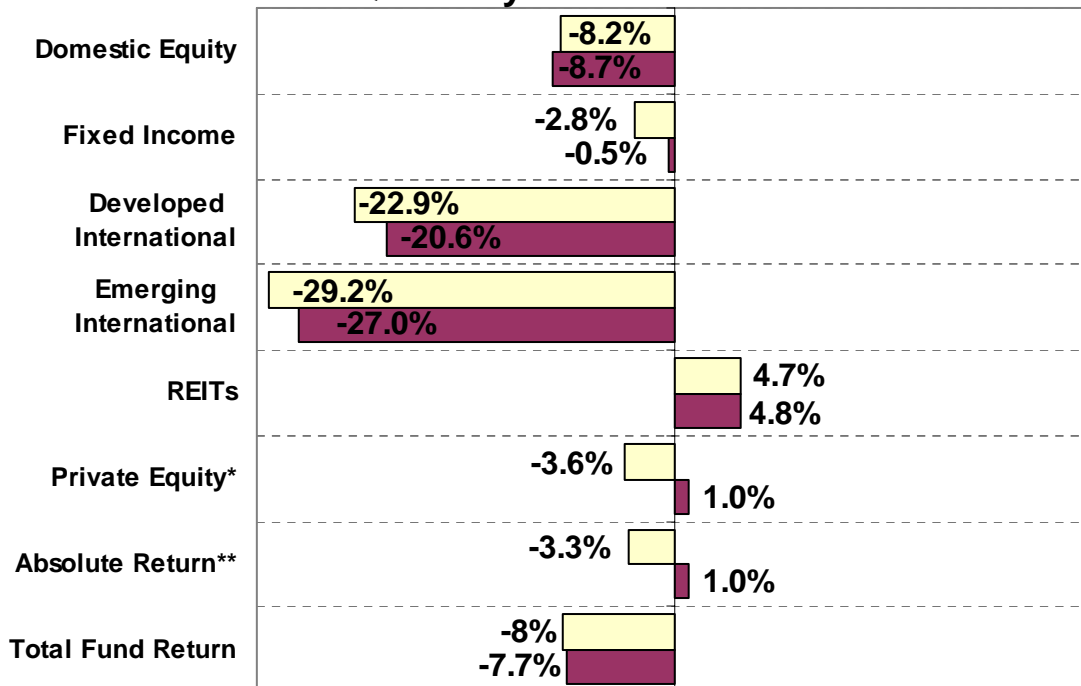
*Percent of actuarial value of assets to plan liabilities.

Fund Performance vs. Policy Benchmarks*

1 Year			5 Year			10 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
-15.4%	-15.1%	64	7%	7%	31	4.8%	4.9%	83

*ERB also has an 8 percent actuarial benchmark for funding purposes.

ERB Quarterly Performance vs. Benchmarks



* Results Lagged One Month

** Results Lagged Two Months

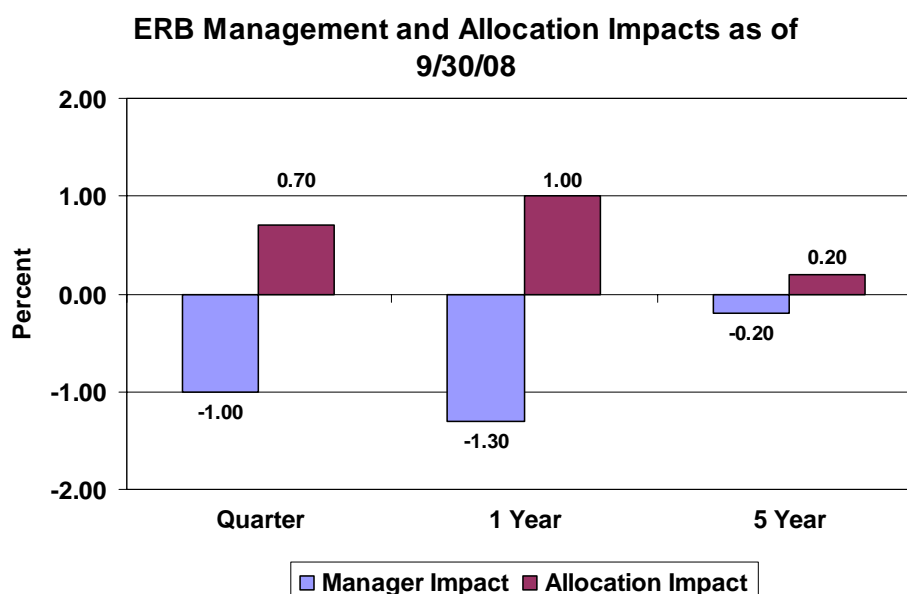
ERB

Benchmark

Fund Balance (in millions)			
September 30, 2008	June 30, 2008	September 30, 2007	September 30, 2003
\$7,985.6	\$8,741.3	\$9,586.0	\$6,172.8

Overview: ERB missed its quarterly policy benchmark by 30 bps and continues to underperform its 12-month benchmark by the same margin. Although negative, the fund's first quarter performance was enough to improve its ranking versus other public funds from the 78th to 47th percentile for one-year returns. ERB ranks in the 31 percentile of U.S. public funds for the five-year period. Over the last 12 months the fund lost \$1.5 billion, of which \$687.6 million occurred in the first quarter for FY09. The decline in the 10-year return to 4.8 percent is a serious concern given that the fund's investments must return 8 percent over the long term to generate sufficient funds to pay benefits.

Management and Allocation Impacts: As in the past, ERB benefited from its asset allocation in the first quarter. By under allocating both domestic and international equity investments relative to policy targets and holding more cash than usual, the fund was able to limit its exposure to two of the worst performing asset classes over the past year. The fund saved more than 70 bps during the quarter and 100 bps for the year as a result of asset allocation alone. Although slightly below its benchmark, ERB's allocation to real estate investment trusts (REITs) returned a positive gain that helped to anchor the portfolio when all other asset classes were down. Manager performance has slipped, costing the fund an estimated 130 bps so far in the 12-month period, 100 of which came in the first quarter of FY09. ERB's returns show a similar pattern to PERA's, where the domestic equity managers posted a slightly positive return relative to the benchmark for the one-year but all other managers underperformed. In particular, the fixed income and absolute return composites underperformed benchmarks by 500 bps and 680 bps, respectively. Although they have hurt fund returns slightly over the past five years, negative impacts from manager performance should lessen as financial markets begin to stabilize.



Special Focus: Permanent Fund Distributions

As noted earlier in this report, investment fund asset values have fallen significantly over the past 12 months. This is a trend which has continued into the second quarter of FY09 and could have considerable effects upon distributions to the general fund.

Statutory Distributions: Each fiscal year the SIC managed permanent funds are required by statute to make annual distributions to the general fund based upon calendar year end asset values. Currently the LGPF distributes 5.8 percent of the average year-end fund values for the immediately preceding 5 calendar years. This amount will decrease to 5.5 percent in 2013 and then to 5 percent in 2016. The process of averaging out year-end fund values is known as smoothing or using a moving average. The STPF currently distributes 4.7 percent of its 5 year moving average to the general fund.

Historical Permanent Fund Distributions		
	STPF	LGPF
FY1994	\$ 133,930,926	\$ 212,409,655
FY1995	\$ 131,291,315	\$ 204,521,642
FY1996	\$ 107,614,189	\$ 203,010,553
FY1997	\$ 133,634,496	\$ 207,416,778
FY1998	\$ 136,307,184	\$ 211,102,400
FY1999	\$ 139,033,331	\$ 215,449,056
FY2000	\$ 141,813,996	\$ 219,819,870
FY2001	\$ 144,650,280	\$ 234,280,130
FY2002	\$ 159,182,592	\$ 258,049,563
FY2003	\$ 170,954,868	\$ 275,683,877
FY2004	\$ 172,434,108	\$ 292,234,566
FY2005	\$ 173,249,124	\$ 350,285,103
FY2006	\$ 171,797,508	\$ 354,156,255
FY2007	\$ 170,972,508	\$ 364,699,515
FY2008	\$ 177,171,816	\$ 390,483,772

Distribution Calculations: As mentioned earlier, the distributions in the chart above were derived from a 5 year moving average. The use of a moving average helps to mitigate volatility of annual distributions. This protects not only state revenues from significant year over year decreases, but also protects the corpus of the fund itself from being drawn down too quickly after sharp year over year increases. By basing fund distributions off of a rolling average the State has mitigated its short-term exposure to bad years such as CY2008. Although state revenues are protected from bad years in the short-term smoothing is not by any means catch all insurance against bad years. The effects of bad annual returns will continue to factor into general fund distribution calculations for an additional four years.

Effects Going Forward: Because of the 5 year averaging process the bad year, in this case CY2008, will have a greater effect on outgoing years than its own year. While these effects can be lessened by future positive fund performance the bad results in this case

Quarterly Investment Report, 1st Quarter - Fiscal Year 2009

will continue to be a drag on distributions to the general fund until 2012. Thus if current market conditions continue throughout CY2009 and beyond, the annual distributions received by the general fund will continue to significantly fall into the next decade. The table below shows future distributions projected by the consensus revenue group in October as compared to estimates made in December of 2007.

October 2008 Projected General Fund Distributions							
LGPF				STPF			
FY	Dec 07 Est	Oct 08 Est	Difference		Dec 07 Est	Oct 08 Est	Difference
2008*	\$390.5	\$390.7	\$0.2		\$177.2	\$177.2	\$0.0
2009	\$433.8	\$433.7	-\$0.1		\$191.6	\$191.3	-\$0.3
2010	\$472.8	\$444.5	-\$28.2		\$203.5	\$193.0	-\$10.5
2011	\$513.1	\$451.8	-\$61.3		\$215.6	\$192.6	-\$22.9
2012	\$556.4	\$459.7	-\$96.7		\$228.9	\$192.6	-\$36.3

*October 08 estimate reflects the actual distribution.

As of October, expected distributions in FY12 decreased by more than \$130 million due to poor fund performance in CY2008. Continued poor performance during the past few months leads us to believe that these projections will be decreased even further during the December revenue estimate. It is therefore imperative to continually monitor fund balances due to their effects upon general fund distributions. Even with optimal fund performance going forward, the long-term effects of decreasing fund values will continue to drag down annual distributions until the bad years are dropped from the 5 year average.